Economic Assessment of the Euro Area

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EXECUTIVE SUMMARY

The recovery in the world economy from the deepest recession since the 1930s strengthened during the first half of 2010, aided by strong policy measures and restocking. The overall performance of the world economy, however, masks considerable variation in the extent of the economic recovery across different regions. China and the emerging economies have recorded the strongest growth rates while the recovery in the industrialised countries is progressing at a more modest pace as the legacy effects of the crisis weigh on the performance of these economies. On the basis of the latest data available, we expect that the gradual weakening of the recovery seen in recent months will continue into 2011. For 2012, we expect world GDP growth to accelerate slightly as economic conditions gradually improve and economic growth slowly returns to its potential.

As shown in Table 1, we anticipate that the recovery in output from the global economic crisis will proceed at a modest pace in 2011. World trade has been losing momentum throughout 2010 as the impact of exceptional monetary and fiscal stimuli begins to wane. The persistence of elevated risk premiums and the sovereign debt problems in Europe are obstructing the return to normality in financial markets which is necessary to underpin a broad-based economic recovery. High unemployment and the implementation of austerity measures to reduce large fiscal deficits built up during the crisis will weaken the pick-up in aggregate demand.

The report contains the results of a simulation exercise which estimates the effects of fiscal policy changes on GDP in the Euro Area. In the absence of fiscal consolidation, GDP growth in the Euro Area would have been lower in 2010. The planned consolidation measures for 2011-12 improve the public finances in the Euro Area by 1.7 per cent of GDP. At the same time, the implementation of the fiscal austerity measures will have a dampening effect on output with GDP growth slowing by perhaps ½ of a percentage point or more in both 2011 and 2012. The analysis highlights the high cost of elevated risk premia. Reverting to pre-recession levels of government risk premia could result in a substantial improvement in general government balances in the Euro Area.

For the Euro Area, we forecast a tentative recovery in output with GDP increasing by 1.6 per cent in 2011 and 1.7 per cent in 2012 following an increase of 1.7 per cent this year. There are several reasons for the relatively modest upturn projected for the Euro Area, including the unwinding of fiscal and monetary stimulus packages, sluggish private household demand, the ongoing repair of household balance sheets, weaker external demand and low growth in fixed investment. In particular, the forecasts contained in this report are critically based on the assumption that the European sovereign debt crisis is contained and is resolved swiftly.

Unemployment increased sharply in many Euro Area countries in response to the crisis but stabilised during mid-2010 as a result of the improvement in economic conditions. Mirroring the divergent economic performance of different countries, the state of the labour market differs significantly across individual Euro Area countries. In Germany, the unemployment rate remained almost constant during the recession as the economy reaped the benefits of unprecedented wage moderation prior to the crisis. Labour market conditions in the Euro Area are expected to remain challenging over the forecast horizon. The unemployment rate is forecast to average 9.9 per cent in 2011 before falling slightly to 9.7 per cent in 2012.

Table 1: Summary of Key Forecast Indicators for Euro Area

	2006	2007	2008	2009	2010	2011	2012
Output Growth Rate	3.2	2.8	0.3	-4	1.7	1.6	1.7
Inflation Rate (Harmonised)	2.2	2.1	3.3	0.3	1.4	1.3	1.5
Unemployment Rate	8.4	7.5	7.6	9.4	10	9.9	9.7
Govt. Balance as % of GDP	-1.3	-0.6	-2	-6.3	-6.3	-5.1	-4.3

Inflationary pressures in the Euro Area are expected to remain subdued in 2011. Recent increases in indirect taxes have contributed to a one-off shift in the price level. However, this effect is expected to diminish over the course of next year. Oil prices are expected to increase only modestly with the result that Euro Area inflation is expected to remain below the 2 per cent threshold in 2011 and 2012. Given the absence of any significant inflationary pressures, the main ECB interest rate is projected to remain at its current low level over the short-term before starting to rise gradually over the period of the forecast in line with the anticipated economic recovery. The main refinancing rate is expected to reach 1.1 per cent by the end of 2011 and 1.6 per cent by the end of 2012.

OUTLOOK FOR THE EURO AREA

1.1 Overview

Since summer 2009, the world economy has been recovering from the deepest and most synchronous recession since the 1930s, supported by strong policy measures and a change in inventory accumulation. The rate of recovery, however, has been different across the regions. Led by China, the emerging economies are growing fast, while most industrialised countries are still suffering from the legacy of the crisis. In industrialised countries production is generally still below the pre-crisis levels and capacity utilisation consequently is low.

China has already begun to reverse its stimulatory monetary policy, while the US and Japan still employ unconventional monetary policy measures in order to activate the economy. In contrast to the latter two economies, the ECB is already planning to terminate its transitory unconventional monetary policy measures.

The Chinese central bank has already started to raise its steering rate. In Japan, the key central bank interest rates are likely to stay low till the end of 2012, while the Federal Reserve, the ECB and the Bank of England are expected to start raising their rates in the forth quarter of 2011. Key bilateral exchange rates are assumed to fluctuate close to the level that prevailed in November 2010.

Regarding fiscal policy, the Chinese stimulus plan is going to end, and in the US the results of recent mid-term elections did in effect remove any room of manoeuvre. In Japan some additional stimulus has been introduced. The Euro Area, countries that have credibility problems due to unsustainable large public debts have already begun to balance their public sectors, while most other members of the Euro Area are about to start the adjustment process.

Inside the Euro Area, countries are experiencing divergent economic developments. While growth is picking up more strongly than expected in Germany, the outlook for countries with severe debt and competitiveness problems, notably Greece, but also Ireland, Portugal, Spain and to some extent Italy, is more subdued. Austerity measures that have been introduced to ensure the sustainability of public finances are depressing their economies in the short run.

The transitory Euro Area crisis management mechanisms managed to reassure investors only for a short time. The decision to establish a permanent crisis mechanism to improve Euro Area governance did not strengthen the stability of the financial markets initially as the new mechanism will obviously increase private creditors' burden in the event that a country runs into financial difficulties. The current difficulties in Ireland stem from concerns about the sustainability of its banking system. The action by the EU and the IMF to provide support for Ireland is also designed to prevent the spread of such concerns to other Euro Area economies.

Global current account imbalances did improve during the recession, but after growth had resumed they started to widen again. The contrasting savings-investments imbalances in the US and in China call for stronger policy measures to support the domestic demand in China and savings in the US.

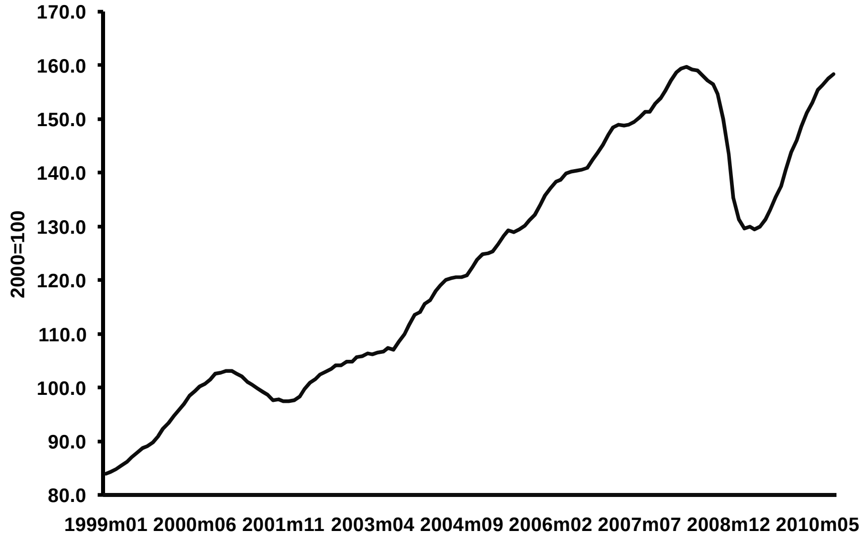
1.2 Global Outlook

1.2.1 KEY DEVELOPMENTS

The recovery from the global economic crisis is losing momentum. Nearly two years have passed since world output reached the low point. Since then – early 2009 – emerging economies have been recovering forcefully; the United States, after a strong start, have seen a modest recovery, while in Europe the recovery has been wildly uneven. A combination of measures to support financial institutions, fiscal stimulus of unprecedented proportions and extremely stimulative monetary conditions – all of this on a global scale – has prevented the free fall that the world economy experienced in late 2008 and early 2009 from turning into a prolonged downturn.

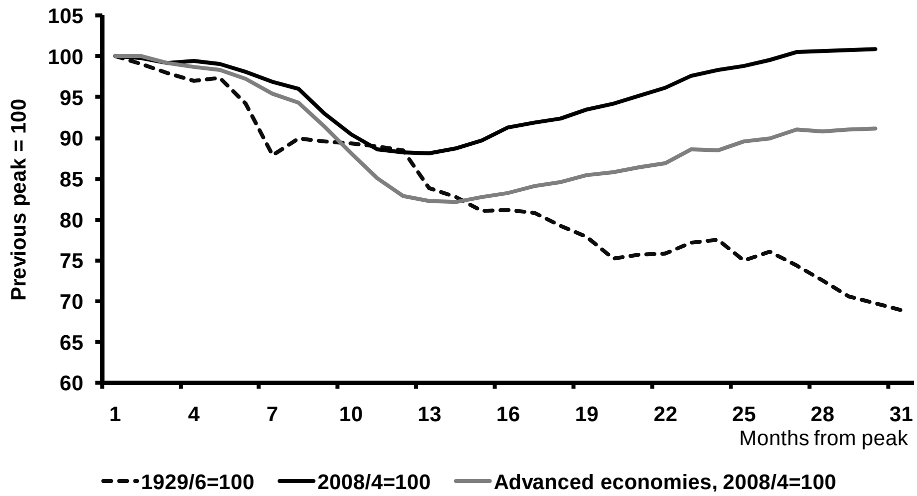
The largely policy-driven turnaround was later on supported by a favourable turn of the inventory cycle in several major economies. Production rebounded first in emerging economies in Asia, which have shown remarkable determination and resilience after having been hit hard by the collapse of their exports. Many advanced economies started to grow again a few months later. In most advanced economies however, output has not yet fully returned to its pre-crisis level (Figure 3). In the Euro Area and Japan it still is considerably lower, the difference being 3 per cent and 4 per cent respectively. In the United States on the other hand, GDP is close to the early 2008 level. World trade is nearly back were it was when it peaked in April 2008, while world industrial production returned to its previous peak level in June of this year (Figure 2).

Figure 1: World Trade, Three Month Moving Average



Source: CPB World Trade Monitor.

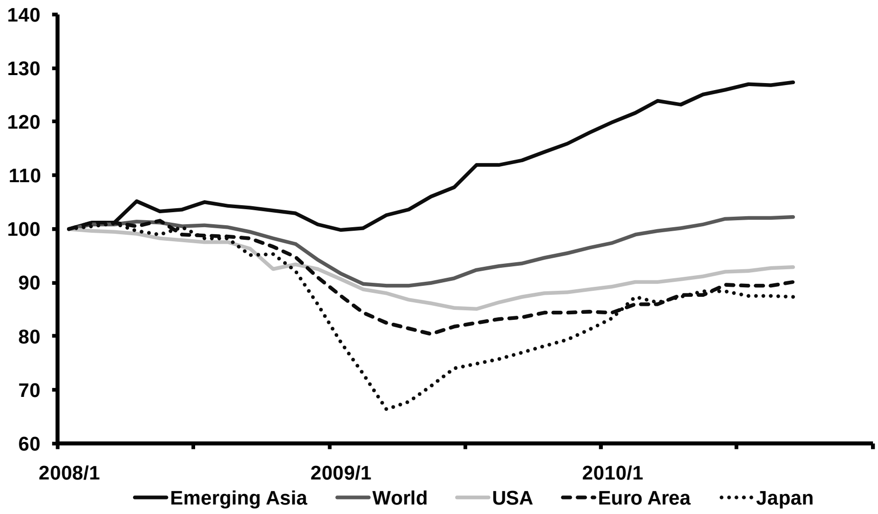
Figure 2: World Industrial Production during the Great Depression in the 1930s and the Great Recession



Source: League of Nations, CPB, ETLA

World trade and world industrial production (Figure 1 and Figure 2) were growing very fast in the beginning of the year, but have been losing momentum ever since. In January trade momentum (the rate of growth over the previous three months) was 6.3 per cent (non-annualised). In August it was 1.9 per cent. In the third quarter, import growth in emerging economies has come to a virtual halt, whereas during the first half of the year imports of emerging economies were driving growth worldwide. Production in China has been growing at a breakneck speed. Inflation has been on the rise throughout the year and is now substantially above the official target rate of 3 per cent per annum. Industrial production growth in China has been slowing gradually however and import momentum turned negative in June. The People's Bank of China has repeatedly raised capital requirements in order to slow bank credit growth. In October it raised its policy interest rate by 25 basis points.

Figure 3: Industrial Production by Area



In the Euro Area, the financial crisis took a new twist when in Spring several governments' lingering financial difficulties started to mount to the point where it became doubtful whether they were capable of solving them without outside official support. The weak creditworthiness of private sector parties, notably mortgage takers and financial enterprises, had been at the core of the financial crisis. Now the crisis of confidence shifted to public sector debt, initially centred around Greek government bonds. In May, an initial attempt by Euro Area governments, the ECB and the IMF to restore investors' confidence in Greece's creditworthiness and to contain the crisis to Greece by offering it loans amounting to 110 billion euro failed on both accounts. Soon the same parties announced a new, much more comprehensive plan, which no longer focused exclusively on one country, but which aimed to support Euro Area governments facing 'exceptional circumstances beyond their control'. This is now called the European Financial Stability Facility. The ECB took the remarkable step of announcing the purchase of sovereign debt at the secondary market. At the time of writing, European heads of government are struggling to agree on a more permanent set of rules for financial and fiscal coordination. This comes at a time when interest rate differentials in Europe are breaking previous records.

The global crisis has caused divergences within the Euro Area to widen. When GDP growth in the region as a whole turned positive in the third quarter of last year, GDP was still declining in Greece, Ireland, and Spain. In Greece it has continued to decline in the third quarter of this year. Employment outcomes vary wildly, the unemployment rate ranging from 4.4 per cent in the

Netherlands to 20.8 per cent in Spain (September figures). Housing market conditions also show divergent trends with conditions in Ireland being particularly worrying.
Leading indicators suggest that trade growth will stabilise at a modest rate in the fourth quarter. Going forward, indications are that trade growth will remain weak in the first half of 2011. Unemployment as well as households' and firms' efforts to decrease indebtedness will continue to depress aggregate demand. Public sector consolidation programs soon will start to bite. Governments in many advanced economies have to undo measures taken previously to neutralise a huge fall in private sector demand. The seriousness of public sector financial stress varies greatly from country to country. The aggregate budget deficit in the Euro Area is expected to be 6.3 per cent of GDP this year, considerably less than the USA figure, 10.9 per cent, while the public debt ratios are at a similar level. Nonetheless, due to the financial difficulties of several 'peripheral' European countries, the focus of the financial crisis is now Europe.

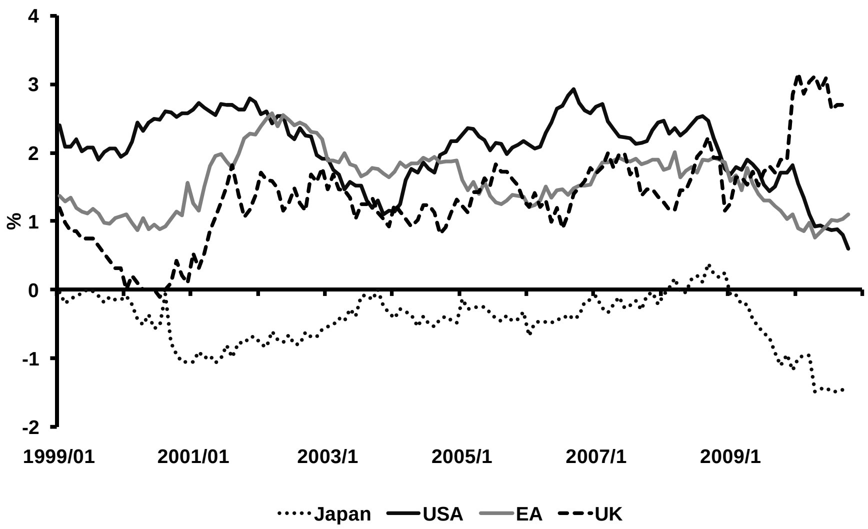
The recently announced new round of quantitative easing in the United States is causing concern in major emerging economies such as Brazil and China. Monetary authorities fear that a new influx of capital may inflate asset prices. This in turn may lead to capital controls or other containment measures. The recent G20 summit in Seoul has failed to achieve consensus on the most divisive issues: current accounts and exchange rate policy. A full return to financial conditions prevailing before the crisis was never to be expected. Risk premiums will remain more or less elevated relative to pre-crisis levels. In Europe the sovereign debt crisis is obstructing the return of normalcy to financial markets. In short, we expect that the gradual weakening of the recovery seen in recent months will continue in the near future. World GDP growth is expected to accelerate slightly in 2012 as economic conditions gradually improve and the economy slowly returns to its potential.

The severe recession in industrialised countries pushed central banks to use unconventional measures after key interest rates had been lowered close to zero. Banks raised their assets substantially by buying government bonds and other instruments either from the markets or also directly from the treasury to support the financial system and the liquidity in the markets. While fiscal policy is generally turning towards a contractionary stance, monetary policy strategies differ. The Federal Reserve introduced a second round of quantitative easing in November 2010. Japanese central banks also continue with these measures, while the European Central bank has become more careful in using these 'transitory' measures. In contrast with the developed countries, emerging economies and China in particular have already suffered from accelerating inflation. The authorities in China have already started to cool the economy first by rising capital reserve requirements and, since this autumn, also interest rates.

Core inflation, excluding the energy and food prices, has generally been on a declining trend in spite of the strong rebound in commodity prices and strong monetary and fiscal policy measures (Figure 4). This reflects partly the low capacity utilisation in the economy as a legacy from the recession. In Japan, the price level has, like the headline inflation rate, been declining since January 2009. Core inflation has hovered below 1 per cent in recent months in the US and at around 1 per cent in the Euro Area and it is expected to continue to moderate.

The US dollar has been rather stable vis-à-vis the Chinese Renminbi, but it has fluctuated strongly vis-à-vis the euro reflecting changes in expectations of growth, monetary policy and recently the problems in European sovereign debt markets. For 2011-2012, the key bilateral rates are expected to remain around the level of mid-November 2010.

Figure 4: Core Inflation (excluding food and energy) in Selected Countries

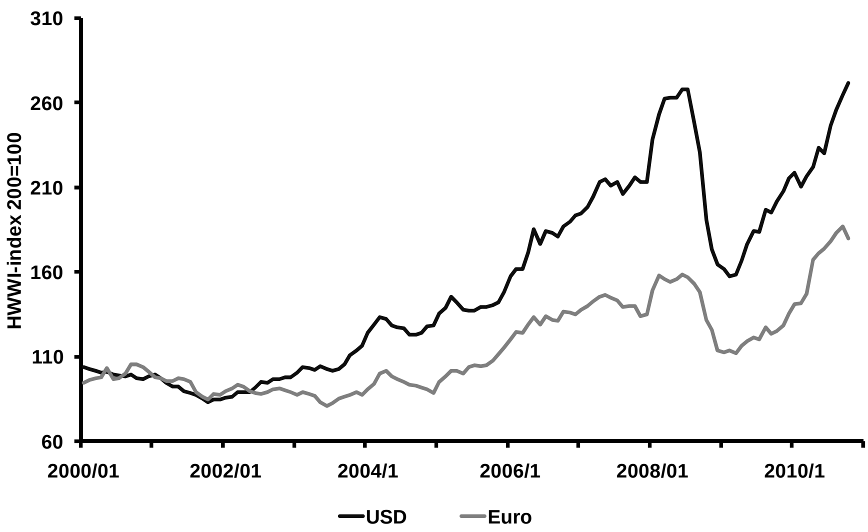


World non-energy commodity prices in US dollars have risen very strongly since reaching their trough in spring 2009. After the recent strong price rise, strengthened by the weakening of the US dollar, the average prices of these commodities exceeded their previous pre-crisis peak by October 2010. Prices expressed in euro have risen even more above the previous peak.

Crude oil prices rose quickly from their lows in winter 2008/9, but unlike non-energy commodities stayed well below their pre-crisis peak. Oil prices have risen, though markets have been very liquid. Demand from emerging markets has been strong, but for e.g. non-OPEC production has risen unexpectedly strongly and has balanced the markets. Oil industry stocks in the OECD countries have been above the 2004-2009 average since April 2010. Crude oil prices have been supported by the weakening of the US dollar. The forecasts in this report are based on the assumption that that oil prices will fluctuate around 80-90 dollars per barrel until 2012.

US non-energy commodity prices in October 2010 were more than three times higher compared to the lows recorded at end-2001 (Figure 5). Crude oil prices were also substantially higher. This significant price level shift is expected to be permanent reflecting the rise of the commodity-intensive Chinese economy and has consequently worsened the terms of trade of industrialised countries.

Figure 5: US Non-Energy Commodity Prices in US Dollars and Euro



1.2.2 RISKS AND UNCERTAINTIES

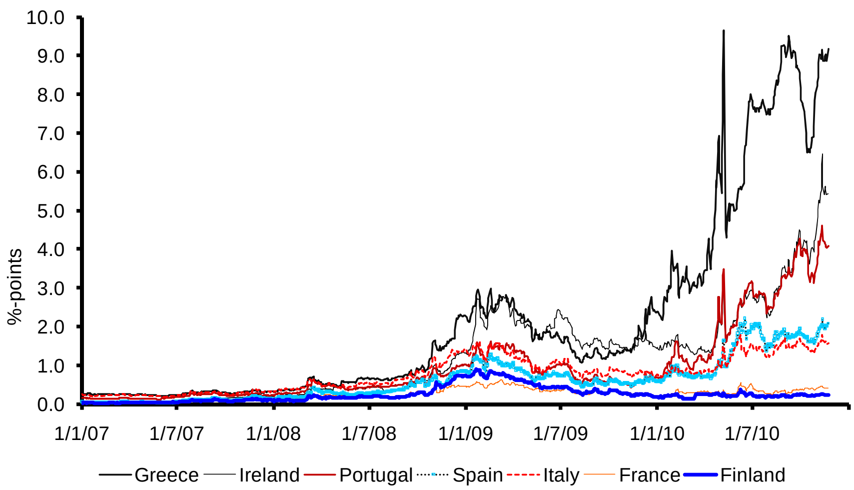
The forecasts contained in this report are subject to high uncertainty. The strong policy measures that were adopted prevented a depression, but caused sovereign debt to rise to critically high levels in many cases. In the Euro Area, Greek Irish and Portuguese bonds carry very high risk premiums in spite of recent stability measures (Figure 6). The process of developing a new permanent crisis mechanism raised premiums further following the suggestion that bondholders could be required share some of the costs of future financial rescue packages implemented under such a mechanism.

Since the summer, ongoing concerns about the sustainability of Ireland's banking system has seen increasing reliance on the ECB for liquidity. At the Irish governments' request (on the 21st of November) the EU and the IMF are offering significant support to tackle the problems in the banking system and to ensure a restoration of order to the public finances (See Box 1). It is hoped that this intervention will make clear the EU's commitment to financial stability and that it will prevent further contagion. Nonetheless, there remains considerable uncertainty which, if not resolved, could have a negative impact on the Euro Area economy.

If the very rapid rebound of commodity prices from the fall induced by the crisis- continues – as it may if world economic activity proves stronger than expected – it may cause inflation problems, in particular in developing countries. On the other hand, weaker-than-expected growth could lead to a substantial decline in commodity prices.

Finally, the improvement in global imbalances during the crisis proved only temporary. Current account imbalances are again growing, in particular in the US (deficit) and China (surplus). The recent attempt in the US to activate growth by a new round of quantitative easing could improve the situation within the country. On the other hand, a depreciation of the US dollar is associated with this measure, having already led to a strong appreciation of several currencies except the Chinese Renminbi, which has been relatively closely tied to the US dollar. This "currency war" could destabilize the international financial markets and could also strengthen the euro, which recently suffered from the sovereign debt crisis. These tensions also risk the revival of trade restrictions.

Figure 6: Ten Year Government Bond Spread versus Germany



Source: Bloomberg, ETLA.

1.2.3 EXTERNAL ENVIRONMENT

Asia

Asia has been growing at a very fast pace, thanks to both a rapid recovery of trade and the strong reaction of domestic demand to fiscal and monetary stimuli, but some signs of deceleration have already emerged in the second and third quarters.

In terms of growth pace, Japan was the notable exception, notwithstanding the high share of its trade within the region due to the severe contraction in domestic demand in the second quarter. The revival of demand in the third quarter (GDP grew by 0.9 per cent quarter-on-quarter) is largely attributable to last-minute consumption before government stimulus measures expired. A negative rebound is likely to occur, and the appreciation of the yen vis à vis the dollar (and therefore vis-à- vis the Renminbi) contributes to an unfavourable outlook for external demand. Policymakers are trying to further expand the fiscal support to the economy with a plan of about €44 billion for employment and growth, and the Bank of Japan, after some intervention in the foreign exchange market to tackle the yen appreciation and a recent cut in interest rates has declared to be ready to expand monetary aggregates. Deflation is an issue, as prices are not likely to respond to expansionary policies.

The other Asian countries are facing various challenges. For most of them the support of fiscal policy is coming to an end and monetary policy is on a tightening path, both to avoid overheating of domestic demand (in many countries the inflation rate is increasing towards its target level) and the possibility that speculative bubbles may emerge. China and India, the most dynamic countries in the region, have already increased interest rates and reserve ratio requirements, and other countries are ready to introduce similar measures. The dilemma for central bankers is related to the possibility that higher interest rates could increase pressures towards an appreciation of their national currency, given the already huge amounts of capital inflows (often "hot" short term money). The current and expected ultra-low interest rate policy of the US (and the monetary policies across industrial countries) is blamed for this, even if, given favourable prospects for Asian growth, a certain degree of pressure for an appreciation of national currencies is likely to occur. On the other side, foreign exchange policies in the area, inclined towards defending exchange rate levels judged too depreciated by other world partners, are blamed for producing current account imbalances in favour of Asian countries. Overall, these reciprocal accusations are producing a lot of political tensions and policy reactions, not solved after the G20 meeting in Korea, which are feeding the risk of a potentially dangerous "currency war".

United States

Economic growth in the US slowed to 0.4 and 0.6 per cent in the second and third quarters of 2010, respectively. This gave rise to some fears that the economy might relapse into recession. Indeed, several of the impulses that have kept up aggregate demand in the final quarter of 2009 and in early 2010 are likely to weaken, among them the deceleration of world trade growth; less stock-building, as the inventory cycle has reached a more advanced stage; and the fading out of fiscal impulses set in 2009.

A more likely outcome than recession is continued moderate growth in domestic demand, as observed in the previous quarters. The corporate sector has already undertaken major adjustments and productivity has been restored. Equipment investment now has expanded for the third consecutive quarter. Similarly, private consumption has proven resilient with quarterly growth rates of about 0.5 per cent since the beginning of the year. With signs of moderation recently, the household savings ratio stood at 5.5 per cent in the third quarter, up from 2.2 per cent in 2007 and households balance sheets start recovering.

The moderate growth foreseen will however not resolve quickly high unemployment and the continued tensions on housing markets. Both are likely to act as a drag on consumption in the forthcoming years. Employment has been virtually flat for the last 12 months, and unemployment stands at a rate of 9.6 per cent. With this situation being prolonged and flows out of unemployment being unusually weak, the number of long-term unemployed is currently on a marked rise. House prices have more or less stabilised at about 30 per cent below the peak level of 2006. The situation remains tense, as a marked percentage of mortgages exceed the values of house collateral and many households therefore still face the risk of foreclosure. Overall, the housing market appears to be stuck in an equilibrium of under-utilisation.

With the announcement of asset purchases of 600 billion US Dollar, the Federal Reserve Bank has recently set another major monetary impulse, the effects of which are still unclear, but gave rise to fears about inflationary tendencies. We envisage the federal funds rate to stay close to 1 per cent until the end of the forecast horizon and a slight rise in US long-term interest rates from currently 2.5 per cent up to 3.2 per cent at the end of 2012. The US general government deficit rose to 11.3 percent of GDP in 2009, with the public debt ratio of 83.0 percent now broadly matching the Euro Area debt ratio. Fiscal policy is expected to be slightly contractionary over the forecast horizon as some fiscal measures set in 2009 phase out.

We expect real US GDP to expand by 2.1 per cent in 2011 and 2.3 per cent in 2012. The unemployment rate is expected to decline below 9 per cent only in 2012. Inflation is forecast to moderate to 1.3 per cent in 2011 and 2012 due to low pricing power of producers and the ongoing slack in the labour market. Given current budgetary plans, the U.S. budget deficit is expected to decline to slightly above 6 per cent by 2012. This implies an increase in government debt to close to 100 per cent of GDP.

United Kingdom

The UK economy has continued on a seemingly robust path of recovery, with GDP growth of 0.8 per cent into the third quarter of this year[1]. But much of this growth over the past year has been driven by the inventory cycle. Whereas the performance of net exports have disappointed, providing a drag on economic growth. The latest data do suggest net exports have provided a positive contribution to GDP growth in the third quarter of this year. But given the large negative contributions from net exports in the first half of this year, it is domestic rather than external sector that has driven the economy forward this year. We expect GDP growth of 1.7 per cent per annum this year.

In 2011 we expect net trade to be the largest contributor to economic growth. The rate of growth in the domestic economy is likely to slow sharply. The contribution from the inventory is assumed to be minimal. The announced fiscal consolidation begins in earnest next year, knocking around ½ percentage point from the UK economy's growth rate through a combination of spending cuts, direct tax and VAT increases[2]. In addition we expect to see consumer spending soften due to the impact of falling real incomes and the wealth effect from declining real house prices. Government and household retrenchment will pose a significant drag on and almost no contribution to GDP growth, respectively next year.

The reliance on external demand for economic growth next year highlights the precarious nature of the UK recovery, despite the very robust rates of growth we have recently seen. According to the National Institute's monthly estimate of GDP, in October 2010 the UK economy was still around 3.6 per cent below its pre-recession peak (March 2008). We do not see the economy returning to this pre-recession peak until 2012.

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[1] This follows GDP growth of 1.2 per cent per quarter in the second quarter of this year. The latest revisions to construction output data have yet to be incorporated into estimates of GDP. These suggest that GDP growth in the second quarter will be revised down to 1 per cent per quarter, ceteris paribus.

[2] The effect on GDP growth is derived from the fiscal multipliers contained within the National Institute's econometric model, NiGEM. For details on these multipliers see Barrell and Kirby (2010).

The UK labour market has proved to be relatively resilient in the face of such a severe recession. The ILO unemployment rate in the UK has remained relatively stable at around 7¾ per cent since the start of this year. The robust performance in the UK labour market has been attributed, in large part, to the sharp adjustment in real wages over the course of the recession. The outlook for the labour market is less benign; given the extent of labour hoarding, and corresponding sharp fall in productivity it is possible for the UK recovery to occur with little job creation.

The government have introduced a more forward-looking fiscal framework than the previous administration. The *Fiscal Mandate* is for the government to return the cyclically-adjusted current budget to balance by fiscal year 2015-16[3]. Also in 2015-16 the government's target is to see net debt, as a share of GDP, in decline. The evaluation of the likelihood of achieving this target as well as producing the official forecasts have been outsourced to a new independent body – the Office for Budget Responsibility. The plans for fiscal consolidation in the UK have evolved over the past couple of years[4]. But it is only next year that these plans begin to take effect. In 2011 the UK government plans a discretionary consolidation equivalent to 2 per cent of GDP. The size of the consolidation is planned to rise over the next five years. The planned consolidation for fiscal year 2015-16 alone is almost 7 per cent of GDP.

The Monetary Policy Committee's (MPC) meeting in November continued their 'wait-and-see' approach. While economic growth has been robust, there are considerable risks to the downside, not least concerns about faltering economic activity in the UK's major trading partners. Unless the UK economy falters dramatically we do not expect the MPC to engage a further round of quantitative easing. But we do not expect the MPC to tighten policy from where is currently is until the second half of next year at least.

CPI inflation is currently more than one percentage point above the target of 2 per cent per annum. Given the sharp fall in demand over the course of the recession this is at first glance surprising. However, temporary factors have conspired to elevate the rate of inflation well above target. The sharp depreciation of sterling since 2007 has boosted import price growth, and also exacerbated the rise in oil prices seen throughout last year. In addition the return of the standard rate of VAT to 17.5 per cent following its temporary cut pushed up the rate of inflation, perhaps by as much as 1 percentage point in 2010.

[3] The specific requirement is to have the cyclically-adjusted current budget (defined as all current receipts less total current expenditure and capital depreciation) in balance by the end of the rolling 5-year forecast horizon.

[4] The current consolidation plan contains much of the future tax and spending changes announced by the previous government.

In our last EFN forecast we expected the rate of inflation to ease back below target in 2011. However, June 2010's *Emergency Budget* included the announcement of a 2.5 percentage point hike in the standard rate of VAT at the start of 2011; we expect this to boost the rate of inflation by just over 1 percentage point, on average, in that year. Although, this is a temporary factor and will not force the MPC to begin to tighten policy. It is only in 2012 when we expect to see the rate of inflation fall below target. However, much of this is simply the base effect from the increase in VAT falling from the calculation. It is only in the years beyond 2012 when underlying inflationary pressures are likely to be greater, as it is from 2013 onwards when we expect the output gap to begin to close.

Current situation and prospects for NMS

Compared to other emerging markets, the economic recovery in the new EU member states of Central and Eastern Europe started relatively late and remained modest. The rise in business and consumer confidence has been only gradual, but in most countries, households have begun to be less cautious in their expenditures. Nevertheless, a high debt burden especially in foreign currencies and higher unemployment put severe down-ward pressure on the dynamics of private consumption. The banking sector continues to face problems on balance sheets because of troubled assets. Therefore, banks remain reluctant to lend to consumers or enterprises. Investment activities are also hampered by excess capacities. Many countries benefited from the moderate recovery in key export markets. In particular, the stimulus programs in Euro Area states helped to boost export demand and improve trade balances. For example, production in the automotive sectors was stimulated by the car scrappage schemes implemented abroad, but this has been only a temporary effect.

The Baltics have lost their place as growth leaders in the region and have undergone huge economic contractions, as domestic house price bubbles burst with capital inflows recorded in the face of massive current account and public deficits. Poland is the only economy in Central Eastern Europe with positive, albeit low growth even during the global recession. Poland has a large domestic market, and households and enterprises have been less burdened with debt than elsewhere. Expanding domestic credit and building business and consumer confidence had been the major factors behind domestic-demand growth in recent years, but the turmoil in international capital markets and an increasing risk aversion in the region on the part of foreign investors acted to constrain domestic demand. EU-financed investments and public projects for EURO-2012 compensated for the contraction of private investment demand. In many cases, namely in Latvia, Hungary, Romania, and Poland, the IMF has stepped in with agreements on balance-of-payments support to reassure investors, maintain confidence in the local currencies, and prevent a sudden exodus of short-term capital from the region.

Growth prospects for the CEE are expected to be moderate for the period ahead. Exports may be dampened by policies directed towards stronger fiscal consolidation in the Euro Area. Moreover the evolution of domestic demand is expected to be rather slow as credit markets remain tight and incomes are depressed by higher unemployment. In the light of the need to retain foreign capital and to counteract large fiscal deficits, monetary and fiscal policies are unlikely to be used to stimulate the economies. We expect Poland and Slovakia to remain the drivers of economic growth, with the Baltic States catching up at a similar pace; Czech Republic, Hungary, Slovenia, Romania and Bulgaria will rather register lower rates of growth, especially in 2011.

1.3 Euro Area Detail

EURO AREA FORECAST

In the Euro Area, the recovery from the global economic slump was initially slow and bumpy. Real GDP grew by only 0.3 percent per quarter on average in the second half of 2009. In the course of 2010 output growth accelerated to an average quarterly rate of 0.6 percent over the first three quarters despite the sovereign debt crisis which led to significant turbulence in financial markets. This pace of recovery is, however, still considered to be modest given the depth of the recession before as it is hardly above usual estimates of the growth rate of potential output. Moreover, the best part of the current phase of the recovery seems to be already behind us.

The preliminary estimate for the third quarter of 0.4 per cent indicates that the upsurge in activity which was very much centred on the manufacturing sector and led to an increase of GDP by 1 per cent was of a temporary nature. Also, the cyclical development was strongly diverse across Euro Area countries. When GDP growth in the region as a whole turned positive in the third quarter of 2009, GDP was still declining in Greece, Ireland, and Spain. In Greece it has continued to decline into the third quarter of this year, when the accumulated output loss since the second quarter of 2009 stood at nearly 5 per cent. GDP in Ireland is about 2 per cent below its 2009Q2 level, while in Spain it is nearly back where it was before the crisis.

In contrast, in Austria, Finland, Germany, Luxembourg, the Netherlands and Slovakia average quarterly GDP growth during the same period has been around 1 per cent (non-annualised). The surprise third quarter GDP drop in the Netherlands is another reminder that Europe is experiencing a fragile recovery. Housing market conditions also show divergent trends, conditions in Ireland and Spain being particularly worrying.

The acceleration of growth in the Euro Area in the first half of the year was primarily due to stronger export growth and a swing in the growth contribution of investment into positive territory. While in the first quarter it was higher inventories that pulled up GDP, in the second quarter fixed investment increased for the first time in two years. Private consumption has remained on a modest upward path since summer 2009 and rose by 0.2 per cent per quarter. For the third quarter no expenditure breakdown is available at the time of writing. Indicators suggest, however, that investment growth has moderated from the strong increase seen in the second quarter with construction investment having fallen again as the impact of the numerous stimulus packages that have been enacted to combat the crisis across the Euro Area have started to fade and fiscal consolidation has begun in an increasing number of countries. Private consumption is likely to have continued to rise slightly, and net exports should have risen further, albeit at a slower pace.

Despite the improvements in production, the situation in the labour market in the Euro Area remains bleak. In response to the upturn in production, unemployment has merely stabilized at the high level of around 10 per cent in the summer 2010, but has most recently started to rise again reflecting the moderation of economic growth. Mirroring the different speed of economic growth as well as the different extent to which the economies are exposed to structural adjustments, the state of the labour market differs strongly across individual Euro Area countries. On the positive side, Germany and Austria stand out where unemployment has already clearly declined following only modest increases during the recession. In Spain and Ireland, the countries in which unemployment has risen most dramatically during the crisis, the labour market continued to deteriorate. Unemployment continued to increase also in France and, not surprisingly, in Greece.

Consumer price inflation in the Euro Area has risen from 1 per cent at the start of the year to 1.9 per cent in October. The headline figure currently appears to be fully in line with the target of the ECB, which is below but close to 2 per cent in the medium term. Part of the increase in inflation is driven by prices for food and energy; the core rate of inflation which excludes these highly volatile items from the HICP has risen by less and is still close to 1 per cent and signals that underlying inflation might still be uncomfortably low. In addition, it should be noted that an increasing part of inflation is due to increases in indirect taxes and thus represents a one-off shift in the price level rather than an increase in the underlying rate of inflation.

On the Euro Area level, higher consumption taxes contribute 0.3 percentage points to the inflation rate according to Eurostat data, but in some countries this factor is much more important. For example in Greece, which in recent months had the highest rate of inflation in the Euro Area (5.7 per cent in

October), almost all of it can be explained by the massive increases in VAT and other consumption taxes that where introduced in the course of this year as part of the efforts to bring the fiscal situation under control. Indirect taxes have also been raised substantially in Spain and Portugal, and as a result inflation is currently slightly above the Euro Area average despite the fact that wage growth in these countries has slowed down dramatically in response to the deterioration in the labour market (and also some structural reforms in the labour markets).

Accordingly, the outlook for an improvement of competitiveness in the tradable goods sector which is needed in order to facilitate a rebalancing of the economies is actually better than the current picture of relative inflation across the Euro Area countries suggests. In the course of next year, when the lower pre-tax hikes price level drops out of the year-on-year comparison, inflation in these countries should drop and given our assumption of only modest further rises in oil prices Euro Area inflation is expected to remain well below the 2 per cent threshold in both 2011 and 2012 at 1.4 and 1.5 per cent, respectively.

The current moderation of the economic recovery is projected to continue over the coming quarters. A number of factors suggest that the economy will have little momentum for some time going forward. The persistent tension in financial markets due to the European sovereign debt crisis certainly is a headwind for the recovery in the Euro Area as it has added uncertainty and on balance led to a tighter fiscal policy. The extent to which this factor is dampening growth is, however, less clear. On the one hand, there is clearly a significant negative impact on growth in those countries where rising risk premia have raised yields on government bonds and led to drastic fiscal tightening. On the other hand, a flight to safety has depressed bond yields in the core countries of the Euro Area, most notably in Germany, and expectations for monetary tightening of the ECB have shifted outward on the time axis.

It is difficult to assess to what extent overall financing costs in the private sector have deteriorated in the Euro Area. Fiscal stimuli that are still present in some countries will progressively fade and fiscal restriction of substantial proportions will be introduced in more and more countries (for an estimate of the effect of fiscal policy changes on GDP in the Euro Area and its individual countries see the section on *Fiscal Policy* below). This will curtail public demand and restrain private consumption which is forecast to grow by only around 1 per cent this year and next. Other reasons to expect sluggish private household demand are bleak employment prospects – unemployment is forecast to remain stubbornly high over the forecast horizon – and the desire of households to restore their balance sheets in countries that have experienced the burst of a house price bubble. External demand growth is forecast to decelerate markedly due to slower growth in emerging economies in combination with ongoing sluggish domestic demand growth in the United States and the United Kingdom, and a higher external value of the euro. Fixed investment is expected to only gradually recover given a still relatively low level of capacity utilization.

A distinct feature of the current recovery is that there are pronounced differences in growth momentum across countries, which are expected to only gradually diminish over the forecast horizon. Due to the massive fiscal tightening, 2011 is expected to mark another year of recession in Greece and Ireland. Growth is going to remain painfully slow in Spain and Portugal, and also Italy is forecast to continue to register subpar growth. Low interest rates and world market growth should lead to relatively robust growth in Germany, Austria and Finland, as these economies have limited need for structural adjustment and are in a better position to benefit from the strong growth of demand in emerging economies.

Overall, we expect real GDP to rise by 1.6 per cent in 2011 and 1.7 per cent in 2012, following an increase of 1.7 per cent this year. With domestic demand being compressed in those countries that have built up serious current account deficits in the years before the crisis (Greece, Portugal, Spain, Ireland) and a relative strengthening of domestic demand in the major surplus economies (Germany, Netherlands, Finland) the Euro Area economy is projected to become more balanced over the forecast horizon.

These growth rates are not significantly above current estimates of growth in potential output in spite of the significant slack in the economies and the pre-crisis level of GDP will not be reached before 2012. There will, however, be pronounced differences with respect to level and evolution of the output gap across countries – with massive underutilization of resources in countries like Spain, Greece or Ireland on the one hand and capacity utilization approaching normal levels in Germany on the other hand – complicating the task of the ECB of setting monetary policy accordingly.

Fiscal Policy

Global fiscal balances deteriorated dramatically in response to the financial crisis, reflecting the cyclical downturn as well as policy responses to the crisis and structural losses in revenue in some countries, related, for example, to the collapse of housing market bubbles. In 2009, all of the Euro Area economies breached the 3 per cent deficit ceiling of the Stability and Growth Pact, with the exceptions of Finland and Luxembourg, and in many cases public finances are expected to deteriorate further in 2010. The average deficit in the Euro Area as a whole widened to 6.3 per cent of GDP in 2009, a rise of 5.7 percentage points since 2007. The financing costs of large deficits, exacerbated by the costs of government interventions directly related to the support of financial institutions, have induced a sharp rise in the stock of government debt. Government debt in the Euro Area as a whole reached 79.2 per cent of GDP in 2009, and our projections suggest that by 2012 it will approach 90 per cent of GDP. Almost all countries in the Euro Area will exceed the 60 per cent of GDP Maastricht limit for government debt. The highest debt burdens are in Greece, Italy and Belgium, where government debt will exceed 100 per cent of GDP this year.

The need for coordinated fiscal expansions at the height of the crisis has given way to the need for credible plans for fiscal consolidation in order to restore public finances and ward off upward pressure on financing costs. Sovereign debt in several economies has come under severe pressure and fiscal consolidation plans were brought forward into 2010 in certain cases. Table 2 reports the planned fiscal consolidation programmes in the Euro Area economies plus the UK, which are underlying this forecast. We investigate the impact of these plans on both the fiscal prospects and the outlook for growth in the Euro Area through a simulation exercise, using the National Institute model, NiGEM.[5]

We define the policy impulse as the expected impact of legislative changes to tax rates and spending commitments introduced in the given year on total government spending or revenue, as a per cent of GDP. A positive impulse represents an expansion (so a tax cut or a spending increase) whereas a negative impulse indicates a contractionary policy. The policy impulses to be introduced in each year are split into those that affect revenue and those that affect expenditure. Revenue impulses are further subdivided into those derived from direct taxation and those derived from indirect taxation. A direct tax impulse is effected through a rise in the rate of income tax. This reduces personal disposable income and slows the economy through the consumption

[5] Further details on NiGEM are available from:
http://nimodel.niesr.ac.uk/nigemweb/nigemweb.php .

channel. An indirect tax impulse is effected through a rise in the rate of consumption tax or VAT. This raises the cost of goods and slows the economy through the price channel. Expenditure impulses are subdivided into those that affect the volume of government spending on goods, services and capital investment, and those that affect personal income through either social benefits or public sector wages. A cut in the volume of government spending on goods, services or capital expenditure feeds directly onto the level of GDP itself, whereas a cut in spending on social benefits or the wage rate of public sector employees feeds into personal disposable income, and slows the economy through the consumption channel. Public sector wage cuts have formed an important part of the programmes in Greece, Ireland, Portugal, Spain and the UK.

Table 2: Fiscal impulses 2010-2012 (positive impulse is a tax cut or an expenditure rise)

	2010				2011				2012				Total 2010-2012
	Direct tax	Indirect tax	Spending (goods and services)	Spending (benefits/ wages)	Direct tax	Indirect tax	Spending (goods and services)	Spending (benefits/ wages)	Direct tax	Indirect tax	Spending (goods and services)	Spending (benefits/ wages)	
Austria	0.9	0.0	0.9	0.0	-0.2	-0.2	-0.4	0.0	-0.2	-0.2	-0.7	0.0	-0.1
Belgium	-0.1	0.0	-0.1	0.0	-0.2	0.0	-0.3	0.0	-0.4	0.0	-0.3	0.0	-1.4
Finland	0.7	0.0	0.3	0.2	-0.1	-0.2	0.1	0.1	-0.3	-0.2	0.0	0.1	0.7
France	-0.1	0.0	0.1	0.0	-0.9	0.0	-0.5	0.0	-0.3	0.0	-0.3	0.0	-2.0
Germany	0.5	0.4	0.1	0.0	-0.3	-0.2	-0.2	0.0	-0.1	0.0	-0.1	0.0	-0.1
Greece	-0.2	-0.3	-1.4	-0.5	-1.8	-0.4	-0.6	0.0	-0.6	-0.1	-1.7	0.0	-7.6
Ireland	-1.1	0.0	-0.7	-0.6	-1.3	0.0	-1.3	-1.2	-0.8	0.0	-0.8	-0.9	-8.7
Italy	0.0	0.0	-0.1	0.0	-0.1	-0.1	-0.3	-0.1	-0.1	-0.1	-0.4	-0.1	-1.4
Neths	0.0	0.0	0.2	0.0	-0.2	0.0	-1.1	-0.1	0.0	0.0	-0.5	0.0	-1.7
Portugal	-0.6	0.0	-0.4	-0.1	-0.4	-0.6	-1.4	-0.6	-0.1	0.0	-0.8	-0.1	-5.1
Spain	-0.7	-0.7	-0.2	-0.1	-0.9	0.0	-0.9	-0.3	-0.5	0.0	-0.7	-0.3	-5.3
UK	-0.2	0.0	-0.2	-0.2	-0.1	-0.8	-0.9	-0.3	-0.3	0.0	-1.0	-0.1	-4.1
Euro Area Total	0.0	0.0	0.0	0.0	-0.5	-0.1	-0.5	-0.1	-0.2	0.0	-0.4	-0.1	-1.8

Regardless of the source of the impulse, a fiscal tightening will necessarily slow the economy down in the short-term. The magnitude of the impact on GDP, the fiscal multiplier, depends on both the instrument used to consolidate finances and several key underlying assumptions, such as the degree of forward looking behaviour in the economy, the degree of openness in the economy, and whether the impulse is temporary or permanent in nature.

The NiGEM model used to run the simulations in this note incorporates the following features. Temporary fiscal impulses tend to have larger short-term output responses, as there is no significant shift in the underlying interest rate path. Permanent fiscal impulses will entail a monetary response eventually, as monetary policy is independent of fiscal policy. With forward-looking financial markets, expected shifts in the interest rate path induce a shift in long-term real interest rates and the exchange rate, offsetting some of the short-term impact on output. Spending multipliers tend to be larger than tax multipliers in the short-term, as a fraction of any tax change is taken up through savings. However, the impact of a tax shift is more protracted, spread out over 3-5 years. Multipliers tend to be smaller in more open economies, as much of the impulse is lost through import leakages. They also depend on the short-term income elasticity of consumption, which reflects the tendency to save versus spend current income. This is often related to the level of liquidity constraints in the economy[6].

The magnitude of fiscal multipliers also depends on whether an impulse is introduced on a unilateral bases, or in coordination with other trading partners. In Euroframe (2008) we estimated the impact of policy coordination on fiscal multipliers in the context of the coordinated fiscal expansion policies. Fiscal multipliers were found to be 0.1-0.2 percentage points higher in the larger Euro Area countries in response to a coordinated fiscal impulse in the Euro Area, US and UK compared to a unilateral fiscal expansion. The same holds for fiscal consolidations, and we can expect the fiscal tightening in the US to have some negative spillovers to the Euro Area.[7]

The main forecasts presented in this report include the fiscal policy plans outlined in Table 2. We run a counterfactual model simulation to determine an ex-ante forecast, based on the assumption that key tax rates and spending commitments are held fixed at 2009 levels, implying a zero policy impulse in 2010-2012. The underlying assumptions of the model simulation include the following: financial markets (long-term interest rates, exchange rates and equity

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[6] See 'Fiscal multipliers to assess consolidation plans' in the National Institute Economic Review, July 2010, pp. F9-F12 for further discussion and estimates of NiGEM model multipliers. This note also compares NiGEM fiscal multipliers to those used by the OECD, the IMF, the European Commission and the ECB, which are broadly similar in magnitude.

[7] This is already incorporated into our main forecast scenario.

prices) exhibit forward-looking behaviour, consumers exhibit myopic behaviour, all consolidation measures are assumed to be permanent. Table 3 compares the ex-ante scenario under these assumptions to our current forecast for the Euro Area.

In the absence of fiscal plans reported in Table 2, GDP growth in the Euro Area would have been slightly lower in 2010. While at the Euro Area level the fiscal stance is neutral this year, this positive impact on output stems from the assumed forward-looking nature of financial markets. The consolidation plans for 2011 and 2012 are announced in 2010, and financial market agents take the impending tightening of fiscal policy as an indication that the ECB will maintain low interest rates for a longer period, as this dampens the outlook for inflation over the medium-term (despite the short-term rise in inflation that stems from certain rises in indirect tax rates).This allows real long-term interest rates to fall by about 0.1 percentage points and the exchange rate to fall in effective terms by about 0.9 per cent relative to where it would have been in the absence of the consolidation measures, stimulating investment and exports relative to the no change in policy scenario.

If we were to run the same scenario with backward-looking expectations in financial markets, where exchange rates are unaffected by shifts in the future interest rate path and long-term interest rates move in line with current short-term rates rather than expected short-term rates, their would be no net impact on GDP in 2010 at the Euro Area level and no shift in the government budget balance between the ex-ante scenario and the final forecast figures for 2010. The impact on GDP growth of the consolidation programmes would be slightly more contractionary in 2011 (¾ percentage point rather than ½ percentage point), as we would miss the offset from the weaker exchange rate and decline in long-term interest rates. Alternatively, in a scenario in which a fiscal consolidation raises the risk premium on government debt, for example if the expected slowdown in growth were to raise doubts about the sustainability of the Euro Area, this could more than offset the positive stimulus to GDP growth in 2010 exhibited in the current model simulation.

Table 3: Euro Area ex ante and post consolidation projections, percentage change

	2010		2011		2012	
	ex-ante	final forecast	ex-ante	final forecast	ex-ante	final forecast
Consumption	0.4	0.6	1.3	0.8	1.5	1.1
Private investment	-0.8	-0.4	2.6	2.1	2.5	2.3
Government expenditure	0.5	0.5	2.8	0.8	1.9	0.3
Stockbuilding(a)	0.5	0.5	0.1	0.1	0.1	0.1
Total domestic demand	0.7	0.9	2.0	1.2	2.0	1.3
Export volumes	10.4	10.8	8.9	7.9	5.6	4.8
Import volumes	9.7	10.2	7.5	5.7	5.3	4.1
GDP	1.5	1.7	2.1	1.6	2.2	1.7
Average earnings	1.3	1.4	1.6	1.8	1.9	1.8
Harmonised consumer prices	1.2	1.4	1.0	1.3	1.6	1.5
Private consumption deflator	1.3	1.5	1.1	1.4	1.6	1.5
Real personal disposable income	0.9	0.8	1.5	0.4	1.5	0.8
Standardised unemployment rate, %	10.0	10.0	9.8	9.9	9.5	9.7
Govt. balance as % of GDP	-6.4	-6.3	-6.2	-5.1	-6.0	-4.3
Govt. debt as % of GDP	84.9	84.6	88.2	87.3	90.7	89.0
Current account balance as % of GDP	-1.0	-1.0	-0.3	0.1	-0.8	-0.3

According to our main scenario reported in Table 3, the planned consolidation measures for 2011-12 improve public finances in the Euro Area by 1.7 per cent of GDP by 2012, indicating that in the absence of these measures we would be expecting a Euro Area deficit of 6 per cent of GDP in 2012. However, the fiscal tightening comes at a cost in terms of output, slowing GDP growth by about ½ percentage point in both 2011 and 2012.

Our final forecast assumptions see government expenditure on goods, services and capital equipment growing by 2 percentage points less in 2011 than under the ex-ante scenario and by about 1½ percentage points less in 2012. This has a strong direct negative impact on GDP in both years, contributing about 60 per cent to the decline in domestic demand in 2011 and 2012 relative to baseline. About 30 per cent of the decline in domestic demand can be attributed to lower consumer spending, which stems from income tax rises, indirect tax rises and also cuts in spending on social benefits and public sector wages. The rest comes from weaker investment growth, which in turn reflects the weaker prospects for GDP as a whole. The decline in domestic demand is partly offset by a stronger positive contribution from net trade, as import demand within the Euro Area falls by more than export demand outside the Euro Area, supported by the small improvement in the terms of trade.

Inflation in our final forecast figures is slightly higher in the short-term relative to the ex-ante scenario, reflecting indirect tax rises in Greece, Spain and

Portugal. This raises Euro Area inflation by about ¼ percentage points in 2010 and 2011. The impact of indirect tax rises drops out by 2012, when inflation is slightly below the ex-ante baseline scenario.

As we discussed above, our model simulations suggest that the planned fiscal tightening measures have reduced 10-year government bond yields in the Euro Area by about 0.1 percentage points. The fiscal consolidation simulations discussed above, however, do not allow for any additional spillovers from the improvement of public finances to the risk premium on government debt. As illustrates in Figure 6 above (from overview section) the spread on 10-year government bond yields remains stubbornly high in Greece, Ireland and Portugal, despite the austere consolidation programmes detailed in Table 2, which point to a cumulative consolidation of 7.6 per cent of GDP in Greece, 8.7 per cent of GDP in Ireland and 5.1 per cent of GDP in Portugal for 2010-2012.

Spreads come at a high cost to the taxpayer. According to NiGEM model simulations, if spreads were to revert to levels observed in January 2010, this would improve the outlook for public finances in Greece by 3½ per cent of GDP by 2012, and in Portugal and Ireland by 1½ per cent and ¾ per cent of GDP, respectively. Put another way, the recent rise in risk premia could be seen as worsening the budget prospects by this amount in these countries, and this will have worsened the Area-wide deficit by 0.2 per cent of GDP. Reverting to pre-recession levels of government risk premia would allow public finances to improve even more rapidly. This would improve the government budget balance in Greece by 6 per cent of GDP by 2012, and reduce our projection for the Euro Area government deficit in 2012 from 4.3 per cent of GDP to 3.8 per cent of GDP.

Box 1: Fiscal Consolidation in Ireland

The Irish government has already implemented an ex ante fiscal adjustment of 2.4 per cent of GDP in 2010 made up of cuts in expenditure and increases in taxes as shown in Table 2. They have also announced a programme of €15 billion in cuts or tax increases (ex ante) spread over the period 2011-14. This package is designed to reduce the government's deficit to around 3 per cent of GDP by 2014.

This planned adjustment has also been broadly accepted by the opposition parties. The intention of the current government is to introduce a budget on 7th December, which will implement cuts or tax increases of €6 billion for 2011. It is also assumed that the 2012 budget will have cuts or tax increases amounting to €4 billion, with the rest of the adjustment taking place in 2013-14.

Using the ESRI's *HERMES* model of the Irish economy it is estimated that an illustrative package of expenditure cuts and tax increases of €15 billion would have a range of effects on the economy ex post.

GDP would be reduced by a cumulative 4 per cent over the 4 years with higher unemployment and emigration as a consequence. The ex post effect on the government deficit would be a reduction in the range of 4½ to 5½ per cent of GDP which would be sufficient to bring the deficit to close to the 3 per cent target by the middle of this decade. In addition, the balance of payments surplus would be increased by around 5 per cent of GDP. This latter effect, stemming from a substantial reduction in imports and a reallocation of resources to the export sector, will transmit some of the effects of the fiscal adjustment to Ireland's EU neighbours, as captured in the simulations using the NiGEM model. The fact that the negative effects of such a large package on the domestic economy are not greater reflects the openness of the economy and the relatively low multiplier. This issue was discussed in Barrell and Holland (2010).

Monetary Policy

Money markets have stabilised somewhat in recent months and the unbalanced developments in monetary aggregates seen in 2009 and early 2010 now seem to be fading out. In the 3rd quarter, growth rates in narrow money M1 decelerated markedly to 7 per cent from 11 per cent in the 2nd quarter. At the same time, money M3 and loans returned to low positive growth rates again, after declines in the first half of the year. Large-scale shifts in the allocation of financial assets to instruments outside M3 – such as withdrawals in overnight deposits and money market funds - appear to have weakened. Together with some increase in money market rates and interest rates on short-term deposits, this indicates an, albeit gradual, move towards a less risk-averse attitude in money markets.

The ECB's monetary policy has remained expansive. Since May 2009, the main refinancing rate has stood at 1 per cent. However, while the US has started another round of quantitative easing the ECB has re-iterated its statements that it would not delay the planned exit from the non-standard liquidity provision schemes set up in 2009. It has also stated that it will remain very cautious with purchases of government bonds of Euro Area member states. Given the moderate growth outlook and continued low inflationary pressure, we expect a very gradual tightening in the course of 2011.

We foresee the ECB to begin raising the main refinancing rate by the end of 2011 and for it to reach close to 2.0 per cent by the end of 2012. The forecast assumes a gradual rise in average Euro Area long-term interest rates from the current rate of about 3 per cent to 3.7 per cent by the end of 2012. Further, it assumes that bilateral exchange rates between major currencies will remain broadly unchanged over the forecast horizon from the levels in November 2010.

Clearly, continued turbulences on financial markets and sovereign debt issues are an important source of risk to the assumptions on interest and exchange rates. The average Euro Area long-term rate currently hides large divergences in risk premia across the Euro Area. Yields on AAA-rated government bond yields declined to about 2.5 per cent in recent months, while risk aversion on government bond markets has continued to increase. With the upturn in Euro Area economic activity and the announcement of quantitative easing in the U.S., the euro had reversed about half of its earlier decline earlier since June and recently stood at about 1.35 vis-à-vis the US Dollar. However, the euro started to decline again with the re-emergence of sovereign debt issues, the full effects of which remain to be seen.

GERMANY

In the course of 2010, the economic recovery in Germany proceeded much faster than expected. Output growth accelerated strongly in the first half of the year. The second quarter showed the highest quarterly growth rate since German unification (2.3 per cent). In line with expectations, real GDP increased at a lower pace in the third quarter (0.7 per cent), but exceeded again the expansion of potential output. Exports have been the main growth engine of the upturn so far. They recovered at an exceptional speed and almost reached their pre-crisis level in the third quarter of 2010. The brightening outlook for exports triggered a substantial rebound in investment in machinery and equipment, although its level is still 15 per cent below the peak in summer 2008. In addition, investment in structures and private consumption both have improved, although only modestly. Overall, the development of domestic demand will account for two thirds of the real GDP increase in the current year.

During the crisis, the German job market has shown a remarkable degree of robustness. On average, unemployment increased only slightly during the crisis, especially in some export led sectors, but started to decline as soon as the free fall of the economy appeared to be stopped in spring 2009. In late summer 2010 unemployment fell below the level registered before the crisis – the lowest numbers since 1992. The exceptionally good performance of the

German labour market, both in an international comparison and relative to labour market responses in previous recessions cannot be explained by the extensive use of short-time work. It is rather the result of structural reforms which led to wage moderation on the macro level and facilitated agreements that raised the potential at the firm level to flexibly adjust working time and wage levels in response to the crisis. Moreover, the nature of the recent recession has been largely confined to industry and perceived as a temporary demand shock (see Box 2).

Public finances did not deteriorate as severely as in many other industrial countries during the crisis although the recession was deep by international standards and despite the fact that the government enacted sizeable stimulus programs. Revenues were not as strongly affected as the recession was not associated with a collapse in the housing market and employment held up relatively well. The vigorous recovery should help to confine this year's general government deficit to around 4 per cent of GDP. The next year will mark the entry into a consolidation process which is scheduled to result in a more or less balanced budget in terms of the structural component by 2016, at least at the federal level.[8] A number of measures will help to reduce the structural deficit by around 0.5 percentage points: Social security contribution rates will be increased by 0.7 percentage points (health insurance: 0.5; unemployment insurance: 0.2); most of the measures taken as part of various stimulus programs will end in 2011, especially extra spending on public investment, reduction of corporate taxes and extra spending on short-time working plans; revenue increases through the introduction of taxes on air traffic and nuclear fuel, reduction of tax deductions for energy intensive industries and increase in the tobacco tax. The process of consolidation is to be continued in 2012, although we expect only a small reduction in the structural budget deficit.

While economic sentiment indicators suggest that there is still a significant momentum in the economy, we expect GDP growth to decelerate substantially over the quarters ahead. The high growth in recent quarters has to be seen against the huge drop in production in previous quarters and could be regarded as a temporary phenomenon after the crisis. Dampening factors include much more moderate increases in external demand combined with a euro appreciation, a change of the orientation of fiscal policy from stimulatory to restrictive, and a turnaround in the inventory cycle.

Domestic demand should, however, continue to expand at relatively robust rates supported by an environment of low interest rates, declining

[8] The so-called debt brake which has been introduced into the constitution requires the federal government to run a structural budget deficit of less than 0.35 percent of GDP by 2016. State governments have to balance their budgets by 2020.

unemployment and rising wages. In particular, private consumption is expected to become a stronger driver of growth. Net exports on the other hand will contribute much less to growth than in 2010 and could even become a drag on growth over the forecast horizon as rebalancing within the Euro Area is expected to proceed.

For 2011 we forecast real GDP growth of 2.1 per cent, following exceptionally strong growth of 3.6 per cent in 2010. While the headline figure for 2012 is slightly less than 2011, this does not imply a further deceleration of growth within the year as the annual growth rate for 2011 is lifted by a high statistical carry-over from the current year. Unemployment is expected to decline further to below 3 million for the first time in almost two decades. Inflation, which has crept up during 2010 mainly due to higher prices for food and energy should continue to gradually rise, with higher labour costs becoming more and more important.

Box 2: Can short-time work explain the German labour market miracle?[9]

While OECD countries on average experienced a rise in unemployment from peak to trough of roughly 3 percentage points, the unemployment rate in Germany stayed almost constant during the Great Recession, although German industry faced a disproportionally large drop in production. It is often argued that the German short-time work scheme prevented unemployment from rising, leading to a massive drop in productivity and working time. If this was really at the heart of the story, the intervention of the government would simply have postponed a more unpleasant state of the labour market or, at least, would have resulted in a protracted period of jobless recovery. However, since the end of 2009 employment has been rising and unemployment was falling even before that, while at the same time short-time work has been reduced.

Therefore short-time work does not provide a sufficient explanation for the good state of the German labour market. First, virtually every recession since the early 1970s was accompanied by a sharp rise in the number of short-time workers, the only exception being the recession following the burst of the dotcom bubble after 2000 (Figure B1) and only after this recession unemployment fell below pre-recession levels so quickly. Furthermore, short-time work is not a German speciality. It is common in many other industrialised countries. Figure B2 depicts the increase in the relative number of short-time workers between 2007 and 2009. Italy, Belgium, Japan and

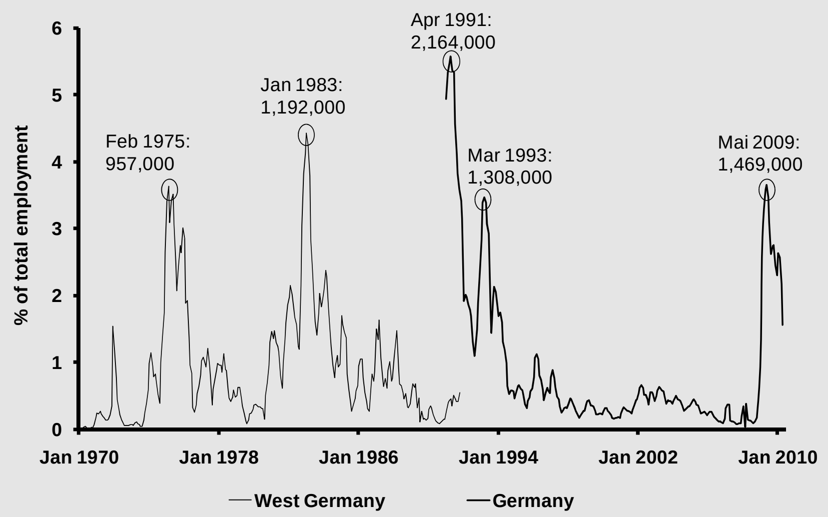
[9] This box was written by Dominik Groll (IfW Kiel). For a more detailed analysis on the factors behind the extraordinary German labour market response in the Great Recession, see Möller (2010) and Boysen-Hogrefe and Groll (2010).

Luxembourg exhibited a rise in the share of short-time workers comparable to that in Germany. The biggest expansion of short-time work took place in Turkey. Thus, relative to total employment the number of short-time workers in Germany was neither exceptionally high compared to previous recessions nor compared to other industrialised countries during the recent recession.

The most important factor behind the labour market success rather was the unprecedented real wage moderation prior to the Great Recession (Figure B3). This stimulated labour demand enormously. Consequently, unemployment declined significantly between 2005 and 2008. For the first time since the 1970s, unemployment fell below its level before the previous recession. The far-reaching labour market reforms between 2003 and 2005 are a very important factor in explaining wage moderation and, thus, the reduction in unemployment. By increasing the incentives to take up employment and by deregulating certain segments of the labour market, the labour market reforms put downward pressure on wages and reduced the structural unemployment rate. When Germany faced the collapse of foreign demand with the onset of the Great Recession, the transition to the new equilibrium with lower unemployment had not been completed, according to our calculations. The underlying process of ongoing transition dampened the visible effects of the recession for the labour market considerably.

A second central factor in explaining the German labour market performance during the Great Recession is the fact that the amount of labour hoarding by firms was unprecedented. This becomes clear when comparing the evolution of real GDP with hours worked and employment (Figure B4). First, hours worked were reduced considerably less than GDP which led to a massive deterioration of hourly productivity. Second, employment decreased by far less than hours worked reflecting a reduction in average working time. Firms resorted to labour hoarding much more than in previous recessions for two reasons. On the one hand, firms were able to hoard labour to a greater extent due to the wage moderation itself and due to increased flexibility in adjusting working time. Here, short-time work can only account for roughly one third of the working time reduction during the crisis (IAB 2010). The rest is due to employer-initiated working time reductions provided for by collective agreements, reducing over-time, and debiting long-term working-time accounts. On the other hand, firms were more willing to hoard labour because they have been increasingly suffering from a shortage of skilled workers and because the recession was perceived as being predominantly exogenous and – at least to a large part –temporary. This stands in contrast to many other countries where the crisis marked the start of a period of structural adjustment correcting imbalances that had developed before, such as reducing an oversized building sector in response to the burst of a property bubble.

Figure B1: Share of Short-time Workers 1970-2010



Source: Federal Employment Agency of Germany.

Figure B2: Increase in the Share of Short-Time Workers 2007-2009

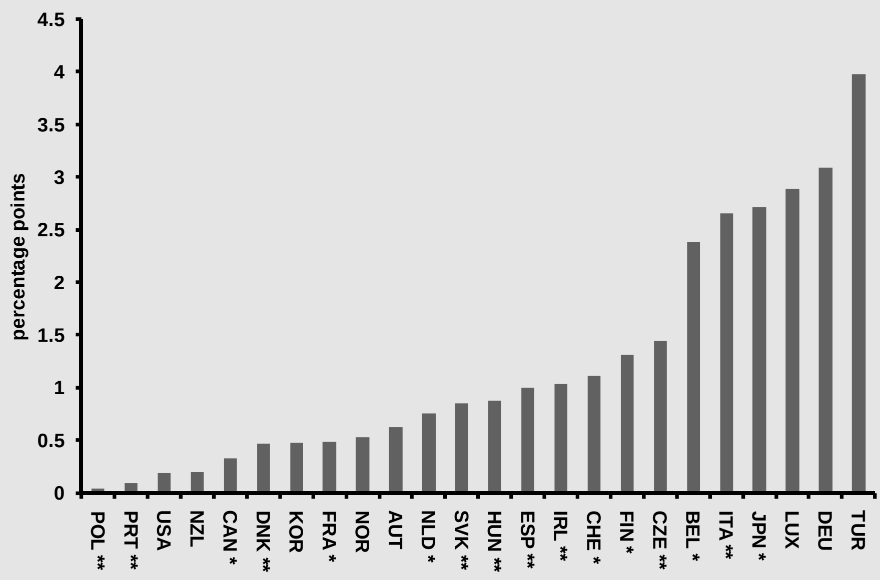


Figure B3: Real Hourly Gross Wage

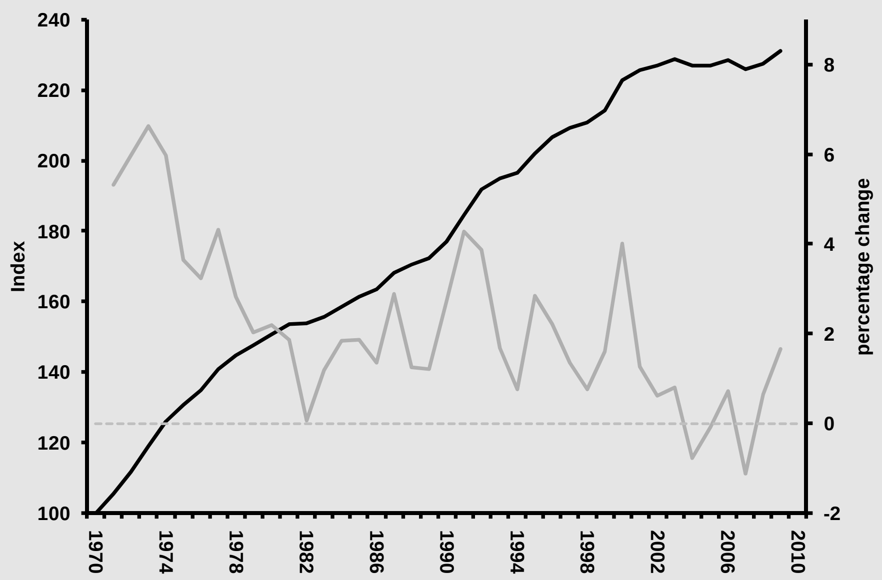
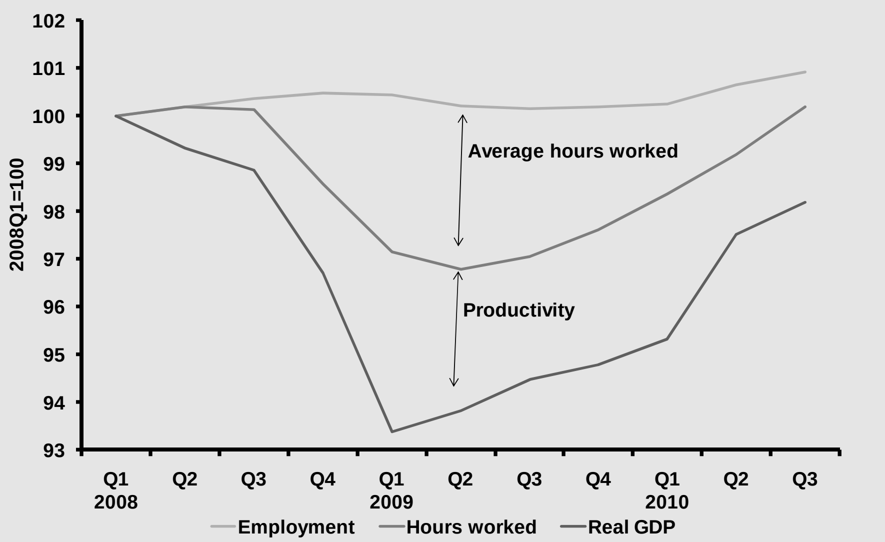


Figure B4: Adjustment in the German Labour Market



FRANCE

French GDP grew by 0.4 per cent in the third quarter of 2010 according to the first set of quarterly national accounts released on 12th November 2010. This was the sixth quarter of positive growth in a row and means GDP has risen by 2.2 per cent since the second quarter of 2009. However, GDP remains 1.8 per cent below its level of the first quarter of 2008. Although French GDP performed better than the Euro Area average during the crisis, and noticeably better than Germany, the French recovery is also less rapid than in Germany.

In manufacturing industry, output rose by 0.7 per cent in the third quarter of 2010 but was still 12.7 per cent below the level of early 2009. Business survey results in the industry and services sectors have regularly improved since Spring 2009 and stood above their long-term averages in September 2010. Households' confidence stopped falling from August 2010 and has remained close to its long-run average. Latest survey data suggest that GDP will grow by around 0.6 per cent in the fourth quarter of 2010.

The recovery of the French economy initially benefited from the support of the fiscal package implemented in response to the crisis. From the second quarter of 2010, inventories provided a clear positive contribution to GDP growth of 0.6 percentage points in the second quarter and 0.3 percentage points in the third quarter respectively. Private investment, both for companies and households stopped falling in the second quarter of 2010 and started to grow at a moderate pace (0.7 per cent per quarter on average). With households' consumption rising by around 0.5 per cent per quarter, domestic demand continues to be the only driver of French GDP growth, while net exports have reduced GDP growth by 0.5 percentage point both in the second and the third quarter of the year.

The crisis has led to a rapid deterioration of public finances and fiscal consolidation will be implemented from 2011 in France as in many advanced economies. French general government borrowing will have increased by 5 percentage points of GDP between 2007 and 2010 while government debt rose by 19 percentage points of GDP. Fiscal policy provided an impulse of 2 per cent of GDP in 2009 but became neutral in 2010, and we expect it to be restrictive in 2011 (-1.4 per cent of GDP) and 2012 (-0.8 per cent of GDP). The government has set the ambitious target of bringing the deficit from 7.7 per cent of GDP in 2010 to 3 per cent of GDP in 2013. In 2011, a major component of fiscal consolidation will be the abolition of a number of tax expenditures (so-called '*niches fiscales*), by around 0.5 per cent of GDP, and which will bear both on companies and households. The government also plans to restrict public spending growth to 0.5 per cent only per annum, well below the average of the last 10 years (2.0 per cent per annum).

Fiscal consolidation comes at a time when the French economy is far from having fully recovered from the crisis. The rate of unemployment rose from 7.6 per cent in early 2008 to 10 per cent in August 2010 (in terms of EUROSTAT harmonised rate). Inflation as measured by the HICP stood at 1.8 per cent in October 2010 up from -0.8 per cent in July 2009 when it reached its last trough, but deflationary pressures are at work, with inflation excluding energy, food and tobacco products having decelerated over that period from 1.5 per cent to 1.1 per cent, and likely to come close to 0 per cent in 2011.

From 2011 on, the positive impacts of inventory cycle will be over and fiscal policy will be tightened. In a situation of high unemployment and large uncertainties about the short-term outlook, we expect households' consumption growth to remain modest over the forecasting horizon (ca. 1.6 per cent per annum), well below the average of the last 10 years (2.6 per cent per annum). Company investment growth will remain modest until excessive production capacities disappear. French exporters succeeded in stabilising their export market shares since the beginning of 2010, but the recent rise of the euro effective exchange rate, which we expect to remain roughly unchanged over the two coming years and world trade deceleration will reduce exports growth. Net exports will keep on reducing French GDP growth over the forecasting horizon. French GDP is projected to grow by around 1.7 per cent per annum in 2011 and 2012.

ITALY

The economic recovery is losing momentum in Italy in common with the situation in other Euro Area countries. Whereas GDP grew by 0.4 and 0.5 per cent quarter-on-quarter in the first half of the year, the recently released estimate for the third quarter signalled a marked deceleration to 0.2 per cent quarter-on-quarter. Industrial production decelerated as well, from 2 per cent in the second quarter to 1.3 in the third. In September, industrial production decreased by 2.1 percentage points month-on-month, and the index is still 18.5 percentage points below the 2008 peak. Due to low business and consumer confidence, we expect a further deceleration for the last month of this year, keeping the year-on-year GDP increase for 2010 at 1 per cent, below the Euro Area average.

The upturn in economic activity has not been strong enough to reverse the negative trend in employment. Provisional data indicate no significant improvement in the third quarter: the seasonally adjusted unemployment rate is 8.3 per cent, while the number of hours of wage supplementation has diminished slightly but it is still at a historically high level.

Twelve-month consumer price inflation doubled in the first six months of the year (from 0.7 to 1.4 per cent), driven by an increase in energy prices. In October it reached 1.7 per cent. Since the beginning of the year the twelve-month increase in the prices of non-food and non-energy goods has held below 1 per cent, and service price inflation has remained historically low.

Reacting to the severe tensions on the government bond markets of some euro-area countries, the Government has brought forward Italy's budgetary adjustment measures to ensure attainment of its objectives. The measures amount to €12 billion in 2011 and further €13 billion in 2012. In this way the net borrowing is expected to be reduced by €12 billion in 2011 and by €25 billion in 2012 and 2013 compared with that on a current legislation basis, in order to achieve the public finance targets indicated in the Stability Programme, that is a deficit to GDP ratio of 3.9 per cent in 2011 and 2.7 per cent in 2012. The adjustment will come mainly from the lower expenditures envisaged by the package (current expenditures especially, deriving from the freeze in civil servant wage increase for the next three years, and the reduction imposed on budgets of local governments), while only one third of the correction will come from revenue measures (mainly from the fight against tax avoidance and tax evasion). In 2011 and 2012 fiscal policy is expected to become restrictive and, according to Government estimates, the expected impact on GDP is around 0.3 percentage points and 0.5 percentage points respectively.

Both this year and in 2011 the recovery is likely to be sustained by export demand, as in similar cyclical phases in the past. Nevertheless, as we expect world trade to expand less rapidly the next two years, export growth is likely to be lower in 2011 and 2012 in comparison to this year. In addition, the dampening effect of the budgetary adjustment will keep domestic demand weak, with household consumption and investment in machinery and equipment growth modest. Construction investment is held down by the still ample spare capacity. All in all, this will result in a slowdown in economic activity compared with the first six months of this year. Driven by the appreciation of the euro, inflation will reach 1.4 per cent in 2011, down from 1.6 per cent this year. We expect a slow improvement in the labour market, mainly driven by a reduction in the number of hours of wage supplementation, whereas employment and the unemployment rate are projected to continue to worsen next year.

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FORECAST TABLES

Annex Table 1: Summary of Key Forecast Indicators for Euro Area[a]

	2006	2007	2008	2009	2010	2011	2012
Output Growth Rate	3.2	2.8	0.3	-4	1.7	1.6	1.7
Inflation Rate	2.2	2.1	3.3	0.3	1.4	1.3	1.5
Unemployment Rate	8.4	7.5	7.6	9.4	10	9.9	9.7
Gov. Balance as % GDP	-1.3	-0.6	-2	-6.3	-6.3	-5.1	-4.3

a GDP data shown in the tables are adjusted for working-day variation.

Annex Table 2: Real GDP in Major Economies

	World	OECD	China	EU-27	Euro Area	USA	Japan	Germany	France	Italy	UK
	Annual percentage changes										
2006	5.1	3.1	11.2	3.3	3.2	2.7	2	3.6	2.4	2.1	2.8
2007	5.2	2.7	13.2	3	2.8	1.9	2.3	2.8	2.3	1.4	2.7
2008	3	0.3	9.3	0.4	0.3	0	-1.2	0.7	0.1	-1.3	-0.1
2009	-0.6	-3.4	8.9	-4.2	-4	-2.6	-5.3	-4.7	-2.5	-5.1	-5
2010	4.8	2.8	10.2	1.8	1.7	2.6	3.6	3.6	1.6	1	1.7
2011	4.2	2.2	9.1	1.8	1.6	2.1	1.1	2.1	1.6	1	1.7
2012	4.2	2.2	9	1.9	1.7	2.3	1.2	1.8	1.8	1.4	1.9

Annex Table 3: Private Consumption Deflator in Major Economies

	OECD	EU-15	Euro Area	USA	Japan	Germany	France	Italy	UK
	Annual percentage changes								
2006	2.2	2.2	2.2	2.7	-0.2	1.1	2.1	2.7	2.7
2007	2.2	2.3	2.3	2.7	-0.6	1.8	2	2.3	2.9
2008	2.9	2.7	2.7	3.3	0.4	1.7	2.9	3.2	3.1
2009	0.3	0.1	-0.2	0.2	-2.1	0.1	-0.6	-0.2	1.2
2010	1.6	2	1.5	1.7	-1.9	1.7	1.2	1.5	4.6
2011	1.4	1.7	1.4	1.3	-0.9	1.5	1.1	1.4	3.4
2012	1.5	1.5	1.5	1.3	0.1	1.8	1	1.4	1.4

Annex Table 4: World Trade Volume and Prices

	World trade volume	World export prices in $	Oil price ($ per barrel)[a]
	Annual percentage changes		
2006	9.4	2.4	63.4
2007	7.3	5.8	70.5
2008	2.8	5.6	95.7
2009	-11	-8.1	61.8
2010	13	3.2	77
2011	8.6	7	81
2012	5.8	3.2	85.7

[a] Based on the unweighted average of the Brent, WTI (West Texas Intermediate) and Dubai oil prices.

Annex Table 5: Interest Rates

	Short-term interest rates				Long-term interest rates			
	USA	Japan	Euro Area	UK	USA	Japan	Euro Area	UK
2007	5.1	0.5	3.8	5.5	4.6	1.7	4.3	5
2008	2.1	0.5	3.9	4.7	3.6	1.5	4.2	4.5
2009	0.3	0.1	1.3	0.6	3.2	1.3	3.7	3.7
2010	0.3	0.1	1	0.5	3.1	1.1	3.3	3.5
2011	0.3	0.1	1	0.6	2.8	1	3.3	3.2
2012	0.8	0.2	1.4	0.8	3.1	1.2	3.6	3.4
2009Q1	0.3	0.1	2	1.1	2.7	1.3	3.7	3.5
2009Q2	0.3	0.1	1.1	0.5	3.3	1.4	3.9	3.6
2009Q3	0.3	0.1	1	0.5	3.5	1.3	3.7	3.8
2009Q4	0.3	0.1	1	0.5	3.5	1.3	3.6	3.8
2010Q1	0.3	0.1	1	0.5	3.7	1.3	3.5	4.1
2010Q2	0.3	0.1	1	0.5	3.5	1.3	3.4	3.7
2010Q3	0.3	0.1	1	0.5	2.8	1	3.1	3.2
2010Q4	0.3	0	1	0.5	2.5	0.9	3	3
2011Q1	0.3	0	1	0.5	2.6	0.9	3.1	3.1
2011Q2	0.3	0.1	1	0.5	2.7	1	3.2	3.1
2011Q3	0.3	0.1	1	0.5	2.8	1	3.3	3.2
2011Q4	0.4	0.1	1.1	0.7	2.9	1.1	3.4	3.2
2012Q1	0.5	0.1	1.3	0.8	3	1.1	3.5	3.3
2012Q2	0.7	0.2	1.4	0.8	3.1	1.2	3.6	3.4
2012Q3	0.8	0.2	1.5	0.8	3.1	1.2	3.7	3.4
2012Q4	0.9	0.2	1.6	0.8	3.2	1.3	3.7	3.5

Annex Table 6: Effective Exchange Rates

	USA	Japan	Euro Area	Germany	France	Italy	UK
	Annual percentage changes						
2007	-4.6	-4.7	3.7	1.5	1.7	1.8	2.1
2008	-1.9	12.9	5.7	2	2.6	2.5	-11.9
2009	7	15.5	5.2	2.4	1.7	2.4	-10.5
2010	-3.1	4.4	-5.4	-3.4	-2.7	-3.1	-0.3
2011	-2.3	4.2	2.3	1	1.1	1.4	-0.1
2012	1	0.8	0.7	0.4	0.3	0.5	0.6

Annex Table 7: Bilateral Exchange Rates

	Bilateral rate against US Dollar		
	Yen	Euro	Sterling
2007	117.8	0.731	0.5
2008	103.4	0.683	0.545
2009	93.6	0.72	0.641
2010	87.8	0.751	0.646
2011	82.8	0.718	0.627
2012	82.9	0.721	0.628
2009Q1	93.6	0.768	0.697
2009Q2	97.3	0.735	0.645
2009Q3	93.6	0.699	0.609
2009Q4	89.8	0.677	0.612
2010Q1	90.7	0.722	0.641
2010Q2	92	0.787	0.671
2010Q3	85.7	0.775	0.645
2010Q4	82.9	0.721	0.629
2011Q1	82.8	0.718	0.627
2011Q2	82.8	0.717	0.627
2011Q3	82.8	0.717	0.626
2011Q4	82.9	0.719	0.628
2012Q1	82.9	0.72	0.628
2012Q2	82.8	0.72	0.628
2012Q3	83	0.721	0.628
2012Q4	82.9	0.722	0.628

Annex Table 8: Euro Area, Main Features of Forecast[a]

	2006	2007	2008	2009	2010	2011	2012
	Annual Percentage Changes						
Volumes							
Consumption	2.2	1.7	0.4	-1.1	0.6	0.8	1.1
Private investment	6.4	4.9	-1.1	-13.4	-0.4	2.1	2.3
Government expenditure	2	2.2	2.2	2.7	0.5	0.8	0.3
Stockbuilding[b]	0	0.1	-0.2	-0.7	0.5	0.1	0.1
Total domestic demand	2.9	2.5	0.3	-3.3	0.9	1.2	1.3
Export volumes	8.8	6.3	0.7	-13.1	10.8	7.9	4.8
Import volumes	8.7	5.8	0.6	-11.8	10.2	5.7	4.1
GDP	3.2	2.8	0.3	-4	1.7	1.6	1.7
Average earnings	2.3	2	3.1	1.8	1.4	1.8	1.8
Harmonised consumer prices	2.2	2.1	3.3	0.3	1.4	1.3	1.5
Private consumption deflator	2.2	2.3	2.7	-0.2	1.5	1.4	1.5
Real personal disposable income	1.8	1.5	1.1	1.2	0.8	0.4	0.8
	Levels						
Standardised unemployment %	8.4	7.5	7.6	9.4	10	9.9	9.7
Government financial balance[c]	-1.3	-0.6	-2	-6.3	-6.3	-5.1	-4.3
Government debt[c]	68.6	66.4	69.8	79.2	84.6	87.3	89
Current account[c]	-0.1	0.1	-1.5	-0.6	-1	0.1	-0.3

[c] As a percentage of GDP.